

## HEARING BEFORE THE SENATE BANKING COMMITTEE

## TURMOIL IN US CREDIT MARKETS: EXAMINING PROPOSALS TO MITIGATE FORECLOSURES AND RESTORE LIQUIDITY IN THE MORTGAGE MARKETS

TESTIMONY OF Scott Stern, Chief Executive Officer, Lenders One

April 10, 2008

Thank you Chairman Dodd and Ranking Member Shelby for the opportunity to testify today. Since this is our first appearance before the committee, I'd like to say a few words about the unique role that Lenders One plays in the mortgage industry. As the country's largest mortgage cooperative, Lenders One represents the nation's "Main Street" lenders. Our 110 shareholder companies originate approximately \$40 billion annually in mortgage loans to make homeownership possible in communities across the United States. Since our inception in 2000, Lenders One companies have made over one million home loans and our members include some of the leading experts in FHA lending. Much like the agricultural cooperatives that enabled family farmers to survive in an era of large scale agribusiness, the Lenders One mortgage cooperative permits locally owned independent mortgage bankers to compete on a level playing field in an industry that in recent years has been dominated by Wall St and a few megaoriginators. Lenders One is founded on the principal that a thriving independent mortgage banking sector increases competition in the industry and provides borrowers with more choice, lower costs, and innovative products.

Our main message today is that from the perspective of the community based lender, there are substantial challenges ahead to the stability of the mortgage and housing market, and we believe the federal government continues to have a role to play in meeting these challenges.

This committee, this Congress and the administration have taken important steps to address the mortgage crisis. Increasing the GSE and and FHA loan limits, progress toward FHA modernization, expansion of mortgage revenue bond authority, and foreclosure counseling are all

positive developments and proposals. However, the mortgage storm is far from over, and more needs to be done to address the root of the problem -- the pool of defective subprime loans with interest rates that are due for significant resets in the coming months. These pools of loans represent a toxin in the mortgage system that has spread far beyond the subprime sector to infect liquidity in the prime mortgage market, accelerate home price depreciation, and cause ripple effects throughout the nation's economy.

As FDIC Chairman Sheila Bair testified before this committee in January, negative housing trends are likely to continue at least through this year. The bulk of subprime hybrid ARM resets are still ahead of us. Over 1 million such loans valued in the hundreds of billions of dollars will reset in 2008. A similar volume of payment option ARMS and interest only loans are also on the horizon. The vast majority of these loans are stated income or low documentation loans, and reports indicate that 75% of borrowers are making the minimum payment. As the housing market has declined and homes have lost value, the ability to refinance out of these loans has become more difficult. Merrill Lynch reports that nearly 9 million households owe more on their mortgages than the value of their home, and for the first time ever aggregate mortgage debt exceeds the total value of homeowner equity, by a staggering \$836 billion.

The economic disruption that Congress seeks to address through stimulus legislation has its root in these distressed loans. We cannot address the broader economic issues without addressing the heart of the problem in the subprime sector. The longer we wait for action, the more foreclosures will mount, and the harder the recovery will be.

Loan modification efforts to date have fallen short of the scale necessary to make a significant reduction in foreclosures. The main federal effort, FHASecure, while well intentioned, is not serving enough borrowers. FHASecure was designed to help those borrowers who had become delinquent due to a reset of a subprime ARM. Credit Suisse has estimated that only 44,000 borrowers would be eligible for a refinance under FHASecure. And the latest numbers from HUD indicate that since the inception of the program in September 2007, just 1500 conversions have been made from a delinquent conventional loan to an FHA loan. HUD's own projections indicate that only 19,000 such loans will be made in 2008 through the FHASecure program.

We believe that an enhanced federally assisted effort to cleanse the market of distressed subprime loans will contribute to stabilizing the mortgage finance system. Chairman Dodd's bill, the Hope for Homeownership Act, is carefully drawn to achieve that goal. The concept is simple: lenders and investors would take a loss by marking the loan down to market value. Borrowers would refinance at a rate higher than their initial teaser rate. No one gets a free ride. The FHA would do what it has historically and successfully done: offer federal insurance on privately originated loans to qualified borrowers who meet FHA underwriting standards. If managed properly, the program will save the loan and save the home. That's a good outcome for everyone, including communities and taxpayers.

Consider a typical example where a borrower has a \$200,000 loan on a home now worth \$180,000 with a subprime hybrid ARM carrying an initial interest rate of 2%. In this scenario,

when the interest rate resets, the borrower's payment will increase significantly, but his ability to refinance will be eliminated because he simply has no equity in his home. In other words, a foreclosure is looming. Our members see these borrowers every day and are unable to help.

Under Chairman Dodd's proposal, the initial \$200,000 loan would be written down to \$162,000 (90% of the home's value) while the borrower's interest rate would be reset at a rate at which he could reasonably be expected to repay. In order to take the loan off the books, the investor is taking a significant loss. And the borrower is paying substantially more than their initial interest rate on the original loan, but in a less risky and more affordable 30 year fixed rate. Where a foreclosure crisis once loomed, a stable and secure loan takes its place.

You can see from the example that Chairman Dodd's Hope for Homeowners approach and the similar approach in Chairman Frank's proposal do not amount to a bailout for anyone. Investors take a loss and borrowers who refinance will pay more. If anything, most of the concern we hear about the proposal is whether there is enough incentive in the prospect of an FHA guarantee on the write down to persuade the investor to take what is likely to be a steep loss. Each investor must make the calculation as to whether to take the certain loss today, or face the potential of further declines in the housing market and the additional future losses that may accrue. That's no bailout.

With regard to the borrower, some have argued that a loan restructuring is unfair to other homeowners who are paying their mortgages and working hard to stay in their homes. We are not unsympathetic to that view. However, the fact is that foreclosures create home equity losses,

tighter credit and a strained tax base. Therefore all homeowners are affected by the foreclosure crisis, not just the borrower who is losing his home. By reducing foreclosures through broader loan modifications available in an expanded FHA refinance program, all homeowners will see the benefits of market stability.

Not every borrower can or should stay in a mortgage loan. Speculators, and borrowers who simply cannot afford any reasonable mortgage, should not be eligible for a refinance. But we believe a significant number of borrowers can responsibly avoid foreclosure.

As a mortgage practitioner who has personally originated over \$300 million in home loans, I also have to say that a knee jerk condemnation of borrowers who took out risky loans is misplaced. The truth is that many of us in the industry were deeply distressed by the growing practice of pushing high risk loans on borrowers who had no reasonable expectation of being able to repay the mortgage. Disclosures were often less than adequate, and faced with a bewildering array of loan terms, borrowers tended to trust their mortgage banker or broker. The broken trust that resulted has damaged borrower confidence in the mortgage industry. I liken the situation to that of a doctor and patient dealing with a medical procedure. The patient bears some reasonable risk. But they don't bear the risk of malpractice by the doctor. In our industry, we have frankly seen too much mortgage malpractice. "Curing" a loan that had a high risk of failure creates no moral hazard. Just the opposite...modifying a loan which probably shouldn't have been made in the first place is the kind of action that can help restore integrity and trust in the mortgage market.

I want to emphasize that the core business of traditional mortgage bankers like Lenders One members was not in subprime lending. In fact, the proliferation of reckless lending products from 2000 through 2007 diminished the conventional and government lending market which forms the backbone of our members business. We weren't making high risk loans, but the collateral damage from these products has impacted us in the form of a disrupted market and a failure of confidence by borrowers and investors alike.

While we support the overall approach of the Hope for Homeowners Act, we do have some suggestions for improving the proposed legislation.

• Remove the foreclosure prevention mandate on the government sponsored enterprises.

The proposed legislation would add a mandated "foreclosure prevention goal" that would be required of Fannie Mae and Freddie Mac. In general, we believe that it is critical that Fannie and Freddie remain focused on mortgage market stabilization by providing a steady and predictable flow of mortgage credit. Policymakers should be wary of placing additional burdens on the agencies at a time when the GSEs are being relied upon to shoulder a central role in ensuring liquidity. In addition, in every other respect, the Hope for Homeowners Act relies on voluntary action by market participants. The addition of a mandatory requirement forcing loan modification quotas on the mortgage market is inconsistent with the thrust of the bill and sets a worrisome precedent for federal policy.

• Create a mechanism to ensure independent mortgage bankers have significant opportunity to participate in FHA refinances

Federal policy should avoid an outcome in which the primary originators of subprime mortgage refinances are the same lenders that made the troubled loans in the first place. Main street mortgage bankers can play an important role in refinancing borrowers out of troubled mortgages. Independent bankers provide a trusted, community based partner for borrowers. We would be happy to work with the committee to explore the best way to integrate local mortgage bankers into the refinance mechanism.

Once again, I would like to thank the Committee for today's opportunity to share the views of independent mortgage bankers, and we look forward to continuing to work with you to bring stability and fairness to the mortgage market.